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No. 92-1046

In The

Supreme Court of the United States

October Term, 1992

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA,

Petitioner,

vs.

JOHN B. CAMP, TRUSTEE, SECURITIES INVESTOR PROTECTION CORPORATION,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

PETITIONER'S REPLY BRIEF

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REPLY TO CAMP AND SIPC'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. RESPONDENTS' "COUNTERSTATEMENT" OF THE QUESTION PRESENTED IS IMPROPER.

Supreme Court Rule 14(a) requires the statement of questions presented to be "concise" and not "argumentative." Respondents, however, preface their "Counterstatement" with the better part of a page of factual argument. Respondents then phrase the Counterstatement in a way which presumes that one of the threshold legal questions presented in this case, whether there is "consistency" between SIPA and 11 U.S.C. § 541(c)(1)(B), has *already* been decided in their favor. More important, Respondents wholly ignore the other question presented for review: whether they are bound to the terms of a standard bond which SIPA required and SIPC requested and approved. Although Respondents pretend this issue does not exist, they devote a significant portion of their brief to arguments bearing upon this very issue.

National Union's initial statement of the questions presented should stand.

II. RESPONDENTS HAVE MADE SEVERAL MATERIAL MISSTATEMENTS CONCERNING THE ISSUE OF GOVERNMENT APPROVAL OF THE STANDARD BOND, INCLUDING THE IMMEDIATE TERMINATION PROVISION AT ISSUE IN THIS CASE.

A. Respondents Have Ignored the Holdings of Cases on Point With the Present Case.

Respondents have ignored well established case law holding that the government and the entities through which it acts are bound by contracts which they approve and require. This principle has been established against the FDIC and FSLIC under facts identical to those of the present case in the cases of *California Union Insurance Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991); *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073

(6th Cir. 1990); *Sharp v. FSLIC*, 858 F.2d 1042 (5th Cir. 1988).

The Fifth Circuit has, on January 27, 1993, reaffirmed the principles first set forth in *Sharp*. In *United States Fire Ins. Co. v. FDIC*, ___ F.2d ___, 1993 W.L. 3850 (5th Cir. 1993), a savings and loan carrying the Standard Bond failed and was taken over by state authorities. The FDIC later presented a claim for losses discovered after the takeover. Again, the FDIC argued that the termination clause was against "federal law and public policy." *Id.* at p. 2. The court, again emphasizing that the FDIC had required use of the Standard Bond, stated that "*Sharp* resolves the FDIC's argument regarding public policy [and] enforceability of § 11(c)." *Id.* Thus, *United States Fire* joins a long line of cases recognizing a public policy supporting the immediate termination clause. The case also reaffirms that the government cannot, during a liquidation proceeding, set aside contracts which it has required pursuant to regulation.

Respondents, without attempting to address the factual identity between the *Sharp* cases and the present case, make a brief attempt to distinguish them by calling them "banking law" while this case is "bankruptcy law." Respondents evidently acknowledge that, were the reasoning of the cases to apply, they would have no justification for their position.

The Respondents' characterization of the cases as "banking law," however, finds no support in the cases themselves. The rationale of governmental fairness and consistency is not limited to the context of bank regulation. Certainly, the cases do not suggest such a limited reading of their reasoning. As noted on pages 12 through 19 of the Petition, the issue in the *Sharp* cases was not "banking" versus "bankruptcy," but was consistency between governmental regulatory actions with governmental positions during liquidation proceedings. The whole point of the *Sharp* cases was that it does not matter from where the government's liquidation powers derive, or how broad they are; they must be exercised consistently with action taken pursuant to regulation. Where the government

requires regulated entities to carry standard bonds, the government is bound by all provisions of those bonds.

Respondents ultimately do not address the direct conflict between the *Sharp* cases and the Eleventh Circuit's reasoning. Although they purport to believe that there is no conflict, they spend over five pages of their brief trying to deny the facts which bring them squarely within the application of the *Sharp* decisions: their approval and requirement of the bond at issue in this case.

B. The Termination Upon Takeover Clause Was Part of the Standard Bond Required by SIPA.

Respondents argue that "SIPC" did not require the bond and therefore is not bound to its terms. *SIPA*, however, did require the bond and SIPC, therefore, is indeed bound to its terms.

SIPA regulates all SIPC members through the following steps. First, SIPA requires all SIPC members to be members of SROs, with the intent to impose the extant body of SRO regulations on SIPC members. § 78iii(c). *See also* Opp.Br. at 13-14. Second, SIPA makes SIPC an advisory body to the SROs for the purpose of determining where new rules might be needed and requesting the SROs to develop such rules, in large part to improve financial responsibility of SIPC/SRO members. § 78iii(e). Third, the SRO's have final responsibility for promulgating and enforcing financial responsibility rules. § 78iii(c).

In the present case the process worked as follows. GSC was required to be a member of NASD, and was thus subject to NASD's rules. In 1970, SIPC advised NASD that bonds were needed to improve the financial stability of SIPC members, and specifically requested NASD to require such bonds. NASD, with SIPC's full knowledge, developed such rules in conjunction with the surety companies, and required members to carry a bond

substantially similar to the Surety Association of America's standard form Stockbroker's Blanket Bond which contained the termination upon takeover clause. Once this rule was effective, it was a requirement of SIPA, through NASD as SIPA's Congressionally-designated regulator of GSC.

Thus, SIPC's arguments that it did not "approve" the termination clause are legally irrelevant. *NASD*, not SIPC, was GSC's governmentally-designated regulator, and it was NASD, in this role, which required the standard bond. Cases uniformly recognize that governmental (in this case Congress through NASD) requirement of the use of a standard bond establishes as a matter of law governmental approval of the bond "and all of its provisions." *California Union Ins. Co. v. American Diversified Savings Bank*, 948 F.2d 556, 562 (9th Cir. 1991). Since SIPC's role was strictly advisory, and NASD's role was regulatory, SIPC's approval is legally irrelevant to the demonstrable governmental approval of the bond.

For this reason, Respondents' cursory statement that SIPC is not an "agency" of the federal government is not only wrong (for the reasons stated by others), but also irrelevant, because the "agency" requiring the standard bond is NASD,[1] not SIPC.

C. Respondents' Arguments that SIPC Never Approved of the Immediate Termination Provision Are Based on Incorrect Factual Statements.

On pages 19 and 20 of its brief and in footnote 12, Respondents make a factual statement that the immediate termination provision at issue in this case was added by rider in 1980 and by amendment to the standard bond in 1987. Thus, Respondents argue, SIPC never approved of

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[1] It should be noted that SIPA § 78iii explicitly makes SROs agents of the government for the purpose of collecting SIPC assessments and enforcing financial responsibility rules under SIPA.

that provision when it approved of the standard bond in 1971. This entire argument is based upon a direct misstatement of fact.

In fact, the termination provision at issue here was part of the standard bond extant in 1970 and 1971, when SIPC requested and approved of NASD's requirement that it be carried by all SIPC members, and has been part of the standard bond since *1936*. Respondents did not support their argument with any evidence. National Union, therefore, is attaching as an appendix the text of the termination clauses contained in the 1970 Stockbrokers Blanket Bond and the 1987 Financial Institution Bond. As can be seen, the immediate termination provisions of the 1970 bond (para. 11(c)) and the 1987 bond (para. 12(c)) are identical.[2]

Respondents are attempting a misdirection play by confusing the issue of "tail" coverage with the issue of immediate termination. The provision which was added by rider in 1980 and by amendment in 1987 was the provision eliminating the trustee's right to purchase an additional discovery period. This is an entirely separate and distinct provision from the immediate termination clause. It is true that SIPC did not approve of its loss of the right to purchase additional coverage. However, this disapproval in itself shows SIPC's consistent position over the years in *recognizing* the force and effect of the immediate termination clause.[3]

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[2] Since Respondents went outside the record to make their argument, National Union assumes that they have no objection to National Union presenting, in the appendix, the documents which establish the true state of affairs.

[3] As Respondent's note, an appeal involving the same issues presented in this case is pending in the Fourth Circuit. Opp.Br. at 6. In that appeal, SIPC has appended to its brief a letter dated November 10, 1977 from SIPC's Chairman to the President of NASD. The letter concerned a proposed rider to the

D. Respondents Concede that SIPC has Always Recognized the Validity and Known the Effect of the Immediate Termination Provision.

Respondents, in making their misdirected argument concerning "tail" coverage, concede the primary point of this case: that SIPC has always recognized and acknowledged that, under the standard Securities Dealers Blanket Bond at issue in this case, coverage terminates upon the appointment of a SIPA liquidator. Respondents begin by asserting on pages 18 and 19 of the Opposition Brief that, prior to 1987, the bond would not have been objectionable to SIPC because there was a provision which "permitted a trustee to make recovery under it." Although the incorrect implication is SIPC was innocent of the bond's immediate termination provision (see *supra*), the full text of provision relied upon is more revealing.

What the bond really authorized was for "the liquidator *to purchase* an additional period within which to discover" losses. Opp.Br. at 18 (emphasis added). Indeed, the quoted bond provision only allowed the liquidator to obtain limited additional coverage – an additional period to discover loss occurring *prior* to liquidation – and stated

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bond which would eliminate the right of the trustee to purchase the additional coverage period. SIPC stated that:

> Indeed, to the extent such a provision became common in policies of this type, SIPC would, in effect, become the underwriter for theft and embezzlement which occurred during a broker-dealer's operations but which were not discovered until after a SIPC trustee was appointed to liquidate the firm.

By this language, SIPC expressly recognized the validity and effectiveness of the termination upon takeover provision. Indeed, SIPC never objected to the immediate termination of coverage, only of its possible loss of the right to purchase additional coverage. This Court should take judicial notice of SIPC's position in other courts on this issue, especially when SIPC documents submitted as part of the briefs materially contradict SIPC's legal arguments in this Court.

that the liquidator *"shall pay an additional premium therefor." Id.* Most important, the quoted provision itself states that the trustee's right to purchase this "tail" coverage only comes into play "if this bond is terminated or canceled as an entirety *by reason of the taking over of the insured by a . . . liquidator." Id.*

Thus, Respondents have acknowledged that, really, SIPC has always known how the immediate termination provision worked. Since Respondents admit that this regime "would not have been objectionable to SIPC," they concede that the termination clause was effective. In addition, Respondent's recognition that extended coverage must be *paid for* demonstrates that the option to extend coverage was a valuable property right belonging to the insurer and not a statutory right belonging to SIPC and its trustees.[4] The inevitable conclusion is that SIPC recognizes and has always recognized that SIPA's reference to the Bankruptcy Code did not permit SIPC trustees to void the termination clause. No other construction of Respondents' argument is possible.

Finally, SIPC's statements should not make this Court lose sight of what SIPC is trying to obtain. SIPC is seeking much more than simply an additional "discovery period" for losses occurring under the old management. SIPC, if successful, will also obtain forced insurance for losses arising from dishonest acts of employees during the liquidation period.[5] Respondents do not explain this

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[4] The issue of SIPC attempting to take from insurer's valuable contractual rights is fully addressed by *amicus*. SIPC's statements fully reinforce the arguments of *amicus* that taking from insurers additional coverage without compensation violates the Constitution.

[5] Respondents misstate how the bond works, apparently in an attempt to soften the impact of SIPC's taking of additional insurance coverage. At page 6 of their Brief in Opposition to the *amicus* brief of Surety Association of America, Respondents assert that the only "property" interest taken is the right to

fact, or that SIPC would obtain through judicial fiat far more coverage than it was *ever* entitled to purchase in the past.[6]

E. Respondents Mischaracterize National Union's Arguments Concerning the Extent to Which SIPA Incorporates the Bankruptcy Code.

Respondents state that National Union argued that only those Code provisions specifically mentioned in SIPA are incorporated, thus rendering § 78fff meaningless. This is not true.

SIPA § 78fff incorporates the procedural provisions of the Bankruptcy Code to the extent they are consistent with SIPA. Substantive provisions are not incorporated unless either SIPA or the Bankruptcy Code specifically so

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discover "past losses." This is manifestly incorrect; if the bond continues in its entirety, as Respondents later claim, then they also obtain coverage for acts occurring and discovered during the liquidation period.

[6] Respondents again misstate how the bond works. At page 6 of their Brief in Opposition to the Insurance Association of America's *amicus* brief, they state that coverage for post-liquidator losses ceases because the insured ceases to engage in continued business transactions. Again, this is not correct; the bond covers dishonest employee acts and is not conditioned upon "doing business." So long as the company has any assets and any employees, there is the potential for covered losses occurring, even during liquidation.

Also, such a period is the period of greatest risk. The demoralization, confusion and loss of supervision arising upon involuntary liquidation provide *both* greater temptation and greater opportunity for employee theft. Cases consistently recognize that the increased risk under these circumstances is legal justification for the immediate termination provision in fidelity bonds. *FDIC v. Aetna Casualty and Surety Co.*, 903 F.2d 1073, 1078 (9th Cir. 1990), *Sharp v. FSLIC*, 858 F.2d 1042, 1045-46 (11th Cir. 1988). Even under the "tail" coverage available to trustees prior to 1980, the insurers never agreed to provide any coverage for this highest-risk period.

state. This is what the *Securities and Exchange Commission v. Aberdeen Securities Co., Inc.*, 526 F.2d 603 (3d Cir. 1975) and *Redington v. Touche Ross & Co.*, 612 F.2d 68 (2d Cir. 1979) cases held. These cases are consistent with the fact that many provisions of SIPA specifically incorporate specific substantive provisions of the Bankruptcy Code, a situation which would not be necessary if they were already incorporated by § 78fff.

F. Respondents Distort the "Plain Meaning" of § 78fff.

Respondents assert that the plain meaning of § 78fff is that all referenced provisions of the Code are incorporated into SIPA by reference. The Eleventh Circuit also adopted this "blanket incorporation" approach. Section 78fff, however, states that SIPA liquidations are "conducted" in accordance with the Bankruptcy Code. The *Aberdeen Securities* and *Touche Ross* cases both held that this explicit reference to "conduct" shows that Congress only intended to refer to Bankruptcy *procedures*. Thus, Respondents' assertions notwithstanding,[7] there is direct conflict between the Eleventh and the Second and Third Circuits on this point. In addition, Respondents' related argument that the only qualification placed on incorporation of the Code is "consistency" is manifestly incorrect, and has been expressly rejected by two courts.[8]

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[7] The fact that the three cases involved different factual situations involving the application of different Code provisions does not at all mean there is no conflict between the Courts. In each case, the extent of the Code's incorporation into SIPA was an issue requiring consideration in order for the courts to reach their final decisions.

[8] Respondents claim that the *Touche Ross* and *Aberdeen* cases can be interpreted as cases evaluating "consistency" between SIPA and the Code. Such a reading, however, necessarily ignores the plain language on the face of the opinions, as Respondents acknowledge on page 29 of the Opposition Brief.

Respondents also assert that § 78fff only prohibits use of Code provisions which conflict with an "explicit provision" of SIPA. Section 78fff, however, states that application must not be inconsistent with "other provisions of this Chapter." Respondents acknowledge, on pages 13 and 14 of the Opposition Brief, that one of SIPA's primary purposes it to have the SRO's upgrade financial responsibility rules and impose those rules on SIPC members. Given this admission, it is inconceivable that, where other provisions of SIPA impose regulations upon SIPC members, Code provisions may be used to override those regulations just because the full text of the regulations is not "explicit" in the language of SIPA itself.

CONCLUSION

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA. respectfully submits that the Petition for Certiorari should be granted.

Respectfully submitted,

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The reasoning of the cases focused on procedural versus substantive incorporation, not consistency. It is this type of direct conflict between Circuits which is a recognized basis for certiorari review.

1970 STOCKBROKERS BLANKET BOND

TERMINATION OR CANCELLATION

Section 11. This bond shall be deemed terminated or canceled as an entirety – (a) thirty days after receipt by the insured of a written notice from the Underwriter of its desire to terminate or cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written request from the Insured to terminate or cancel this bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another business entity. The Underwriter shall, on request, refund to the Insured the unearned premium, computed pro rata, if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Underwriter, or if terminated or canceled as provided in sub-section (c) or (d) of this paragraph. The Underwriter shall refund to the Insured the unearned premium computed at short rates if this bond be terminated or canceled or reduced by notice from, or at the instance of, the Insured.

1987 FINANCIAL INSTITUTION BOND

TERMINATION OR CANCELATION

Section 12. This bond terminates as an entirety upon occurrence of any of the following: (a) 60 days after the receipt by the Insured of a written notice from the Underwriter of its desire to cancel this bond, or (b) immediately upon the receipt by the Underwriter of a written notice from the Insured of its desire to cancel this bond, or (c) immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal officials, or (d) immediately upon the taking over of the Insured by another institution, or (e) immediately upon exhaustion of the Aggregate Limit of Liability, or (f) immediately upon expiration of the Bond Period as set forth in Item 2 of the Declarations.